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Reporting Partnership, S Corporation, and Farm Income

Income or loss from partnerships and S corporations is reported on Schedule E. However, if you have a loss and are not a material participant in the activity, you must compute your allowable loss on Form 8582; the loss is subject to the passive activity restrictions detailed in Chapter 10. Most limited partners are subject to the loss restrictions.

An S corporation election allows an incorporated business to avoid payment of corporate income taxes while providing the owners with the legal advantages of the corporate form, such as limited liability. S corporation shareholders are taxed on their share of the corporation's income, deductions, losses, and tax credits. The rules for making an S election and the tax reporting rules are explained in this chapter.

New law changes for S corporations, generally effective after 1996, are discussed in ¶45.14.

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¶45.1 Forms of Doing Business

If you are operating alone, your choice is between operating as a sole proprietor or incorporating. If you are going to operate with associates, your choice is between a partnership or corporation, which may for tax purposes be either a C or S corporation.

You may also consider organizing your business as a limited liability company (LLC). LLCs are a comparatively new business form devised to get around S corporation restrictions. An LLC gives the advantage of corporate limited liability without the requirement of structuring the business as an S corporation. LLCs are discussed further at ¶45.15.

The simplest way to operate is as a sole proprietor, but if you are concerned with limiting your personal liability, incorporation is generally advantageous.

If taxes were the only test for a business form, you would choose an unincorporated form of doing business, such as a sole proprietorship or partnership. The tax cost of operating a corporation that reports as a C corporation is generally more than that of operating as a sole proprietor or partnership because the corporation is subject to tax and because corporate income received by you is also taxable on your personal tax return. If you must incorporate, an S corporation election can approximate the tax cost of an unincorporated business.

Income-splitting techniques may minimize the double taxation of C corporations. As a general rule, in splitting income between yourself and a corporation, you must try to place into two low tax brackets income that would normally be taxed in one high bracket. You split business income between yourself and a corporation by drawing from the C corporation amounts which it then deducts from its gross income. Drawing salary as a stockholder-employee is the usual method of splitting income. Sometimes you can also get income-splitting by drawing interest on loans you have made to the company, but this method is far more susceptible to IRS disallowance than salary withdrawals. Another means is payment by the company of expenses you incur in entertaining customers and traveling on business trips; this too is subject to IRS review and possible disallowance. However, in all cases, to the extent a corporation can deduct payments to you, there is only one tax.

LAW ALERT: Corporate Tax Reporting Without Incorporation

The IRS has proposed a “check-the-box” election of either corporate or partnership tax treatment by unincorporated businesses.

The check-the-box election would relieve newly formed partnerships and LLCs of having to incur the time and expense of convincing the IRS to allow pass-through partnership tax status where some corporate characteristics are present. The election would be allowed on the adoption of final regulations.

IRS’s proposed “check-the-box” election. The IRS proposal would allow an unincorporated entity with two or more members to make the election between unincorporated or corporate tax status. Partnership treatment would automatically apply for newly formed businesses with at least two members unless an election of corporate treatment is filed. A single-owner business could not elect partnership status, but could choose to be classified as an association taxable as a corporation instead of a sole proprietor.

If the prior classification status were changed by an election, from corporation to partnership or from partnership to corporation, the regular rules for liquidations or incorporations would apply.

An election made under the regulations could not be changed during a 60-month period.

The Supplement will have an update if the proposed check-the-box rules are adopted as final regulations.

¶45.2 How Partners Report Partnership Profit and Loss

A partnership files Form 1065, which informs the IRS of partnership profit or loss and each partner’s share on Schedule K-1. The partnership pays no tax on partnership income; each partner reports his or her share of partnership net profit or loss and special deductions and credits, whether or not distributions are received from the partnership, as shown on Schedule K-1. Income that is not distributed or withdrawn increases the basis of a partner’s partnership interest.

Your share reported to you on Schedule K-1 (Form 1065) is generally based on your proportionate capital interest in the partnership, unless the partnership agreement provides for another allocation.

Your partnership must give you a copy of Schedule K-1 (Form 1065), which lists your share of income, loss, deduction, and credit items, and where to report them on your return. For example, your share of income or loss from a business or real estate activity is reported on Schedule E and is subject to passive activity adjustments, if any. Interest and dividends are reported on Schedule B, royalties on Schedule E, and capital gains and losses on Schedule D. Your share of charitable donations is claimed on Schedule A if you itemize deductions. Tax preference items for alternative minimum tax purposes are also listed.

Health insurance premiums. A partnership that pays 1996 premiums for health insurance for partners has a choice. It may treat the premium as a reduction in distributions to the partners. Alternatively, it may deduct the premium as an expense and charge each partner’s share as a guaranteed salary payment taxable to the partner. The partner reports the guaranteed payment shown on Schedule K-1 as nonpassive income on Schedule E and may deduct 30% of the premium on Line 26, Form 1040.

Partnership Elections

The partnership, not the individual partners, makes elections affecting the computation of partnership income such as the election to defer involuntary conversion gains, to amortize organization and start-up costs, and to choose depreciation methods, including first-year expensing. An election to claim a foreign tax credit is made by the partners.

Guaranteed salary and interest. A guaranteed salary which is fixed without regard to partnership income is reported as ordinary income. If you receive a percentage of the partnership income with a stipulated minimum payment, the guaranteed payment is the amount by which the minimum guarantee exceeds your share of the partnership income before taking into account the minimum guarantee.

Interest on capital is reported as interest income.

Self-employment tax. As a partner, you pay 1996 self-employment tax on your partnership profits, including a guaranteed salary and other guaranteed payments. The self-employment tax is explained in Chapter 46. Limited partners do not pay self-employment tax, unless guaranteed payments are received; *see* ¶46.2.

Special allocations. Partners may agree to special allocations of gain, income, loss, deductions, or credits disproportionate to their capital contributions. The allocation should have a substantial economic effect to avoid an IRS disallowance. The IRS will not issue an advance ruling on whether an allocation has a substantial economic effect. If the allocation is rejected, a partner's share is determined by his or her partnership interest.

To have substantial economic effect, a special allocation must be reflected by adjustments to the partners' capital accounts; liquidation proceeds must be distributed in accordance with the partners' capital accounts, and following a liquidating distribution, the partners must be liable to the partnership to restore any deficit in their capital.

If there is a change of partnership interests during the year, items are allocated to a partner for that part of the year he or she is a member of the partnership. Thus, a partner who acquires an interest late in the year is barred from deducting partnership expenses incurred prior to his entry into the partnership. If the partners agree to give an incoming partner a disproportionate share of partnership losses for the period after he or she becomes a member, the allocation must meet the substantial economic effect test to avoid IRS disallowance.

See IRS regulations to Code Section 704, IRS Publication 541, and Form 1065 instructions for further details.

Reporting transfers of interest to IRS. If you transfer a partnership interest that includes an interest in partnership receivables and appreciated inventory, you must report the disposition to the partnership within 30 days, or, if earlier, by January 15 of the calendar year after the year of the transfer. The partnership in turn files a report with the IRS on Form 8308. You must also attach a statement to your income tax return describing the transaction and allocating basis to the receivables and inventory items. The IRS wants to keep track of such dispositions because partners have to pay ordinary income tax on the portion of profit attributable to the receivables and inventory.

Gains on the sale or exchange of property between a partner and partnership, or between two partnerships, are treated as ordinary income if more than 50% of the capital or profits interest is owned, directly or indirectly, by the same person or persons.

Within 30 days of your transfer, provide the partnership with a statement that includes the date of the exchange and identifies the transferee (include Social Security number if known). You can be penalized for failure to notify the partnership. You and your transferee should receive a copy of the Form 8308 which the partnership will send to the IRS along with its Form 1065.

Generally, the partnership must file a separate Form 8308 for each transfer but the IRS may allow a composite Form 8308 for the calendar year if there were at least 25 reportable transfers.

Recognition of gain by partner on distribution of contributed property. Under IRS regulations, a partner's transfer of appreciated property to a partnership may be treated as a disguised sale or exchange where the partner receives a subsequent distribution from the partnership within a two-year period.

Under a more restrictive law (Code Section 737), a partner who contributes appreciated property to a partnership may incur tax on the pre-contribution gain if within five years *other* property is received from the partnership that is valued at more than the partner's basis in the partnership. This pre-contribution gain rule applies to distributions from a partnership to a partner after June 24, 1992.

These rules are complicated and hedged with restrictions. Consult a tax advisor before making transfers of appreciated property to, or taking distributions from, a partnership.

WHEN A PARTNER REPORTS INCOME OR LOSS

You report your share of the partnership gain or loss for the partnership year which ends in your tax reporting year. If you and the partnership are on a calendar-year basis, you report your share of the 1996 partnership income on your 1996 income tax return. If the partnership is on a fiscal year ending March 31, for example, and you report on a calendar year, you report on your 1996 return your share of the partnership income for the whole fiscal year ending March 31, 1996—that is, partnership income for the fiscal year April 1, 1995, through March 31, 1996.

A partnership generally may use a fiscal year only if a business purpose supports its use. However, a newly organized partnership may elect a fiscal year that allows a deferral period to owners of no more than three months. This "Section 444" election is made on Form 8716. Form 8716 must be filed by the *earlier* of: (1) the due date (without extensions) of the tax return for the elected fiscal year, which is the 15th day of the fourth month following the close of the elected year, *and* (2) the 15th day of the fifth month after the first month of the elected fiscal year. If a business purpose claim is made to support a fiscal year, a Section 444 election may be made as a "backup" in case the business purpose request is rejected by the IRS.

A calendar-year partnership may not make a Section 444 election to change to a fiscal year. This is because the deferral period of the tax year that is being elected may not exceed the deferral period of the year being changed, which is zero for calendar-year partnerships.

If a Section 444 election is made, a special tax payment must be computed for each fiscal year and if the computed payment exceeds $500, it must be paid to the IRS. The tax payment is figured and reported on Form 8752. The tax does not apply to the first tax year of a partnership's existence but Form 8752 must still be filed. In later years, a refund of prior payments is available to the extent the prior payments exceed the payment required for the current fiscal year. For example, if the required payment was $12,000 for the fiscal year July 1, 1996–June 30, 1997, and the required payment for the fiscal year starting July 1, 1997, is $10,000, a $2,000 refund may be claimed on Form 8752. Refunds of prior-year payments also are available if the fiscal-year election is terminated and a calendar year adopted or if the partnership liquidates.

See *IRS Publication 541 for further information on partnership reporting.*

¶45.3 Partnership Loss Limitations

Your share of partnership losses may not exceed the adjusted basis of your partnership interest. If the loss exceeds basis, the excess loss may not be deducted until you have partnership earnings to cover the loss or contribute capital to cover the loss. The basis of your partnership interest is generally the amount paid for the interest (either through contribution or purchase) *less* withdrawals plus accumulated taxed earnings that have not been withdrawn.

For partnership years beginning after September 18, 1988, the IRS does not allow a partner to increase basis by accrued but unpaid expenses such as interest costs and accounts payable. However, basis is increased by capitalized items allocable to future periods such as organization and construction period expenses.

Partners are subject to the "at-risk" loss limitation rules. These rules limit the amount of loss that may be deducted to the amount each partner personally has at stake in the partnership such as contributions of property and loans for which the partner is personally liable. *See* ¶10.17 for a discussion of the "at-risk" rules.

Furthermore, if the IRS determines that a tax-shelter partnership is not operated to make a profit, deductions may be disallowed even where there is an "at-risk" investment.

Finally, any loss not barred by these limitations may be disallowed under the passive activity rules discussed in Chapter 10.

¶45.4 Unified Tax Audits of Partnerships

Tax audits of both a partnership of more than 10 partners and its partners must be at the partnership level. To challenge the partnership treatment of an item, the IRS must generally audit the partnership, not the individual partner. To avoid a personal audit of a partnership item, a partner should report partnership items as shown on the partnership return or identify any inconsistent treatment on his or her return. Otherwise, the IRS may assess a deficiency without auditing the partnership.

For a partnership-level audit, the partnership names a "tax matters partner" (TMP) to receive notice of the audit. If one is not named, the IRS will treat as a TMP the general partner having the largest interest in partnership profits at the end of the taxable year involved in the audit. Notice of the audit must also be given to the other partners. All partners may participate in the partnership audit. If the IRS settles with some partners, similar settlement terms must be offered to the others.

Within 90 days after the IRS mails its final determination, the TMP may appeal to the Tax Court; individual partners have an additional 60 days to file a court petition if the TMP does not do so. An appeal may also be filed in a federal district court or the claims court if the petitioning partner first deposits with the IRS an amount equal to the tax that would be owed if the IRS determination were sustained. A Tax Court petition takes precedence over petitions filed in other courts. The first Tax Court petition filed is heard; if other partners have also filed petitions, their cases will be dismissed. If no Tax Court petitions are filed, the first petition filed in federal district court or the claims court takes precedence. Regardless of which petition takes precedence, all partners who hold an interest during the taxable year involved will be bound by the decision (unless the statute of limitations with respect to that partner has run out).

Partnerships with 10 or fewer partners may elect to come within the unified audit procedures, provided all of the partners are individuals or estates.

S Corporation Election

¶45.5 Tax Advantages of an S Corporation

An S corporation election allows an incorporated business to avoid paying income tax on corporate income, thus eliminating the double tax feature of corporate operations while retaining limited liability and other advantages of doing business as a corporation.

When election is advisable. You will generally make an S election when you cannot take sufficient money out of a corporation without subjecting some or all of it to the double tax, or when a special advantage is offered by an S election. For example, in the early years of the corporation's existence, substantial losses may be expected. The S election allows the pass-through of operating losses to stockholders who may have substantial income from other sources to offset these losses.

If you are in a personal tax bracket exceeding the corporate tax rate, an S election may not be advisable unless other S corporation features will provide you tax benefits. If you already are operating under an S corporation election, you may want to consider a switch to regular C corporation status. However, this decision requires careful analysis by an accountant because new elections and corporate tax reporting involve tax consequences other than current tax

liabilities. You must realize that regular corporate reporting involves double taxes: (1) the corporate tax, and (2) personal taxes on dividend distributions and later dispositions of your stock. Finally, switching between S corporation or partnership reporting and C corporate reporting involves technical adjustments.

The S corporation files a return on Form 1120S, which informs the IRS of corporate net earnings and losses and the stockholders' shares of income or loss items which they report on their personal tax returns. This tax reporting procedure is similar to that required of partnerships.

An election is not advisable for an existing company which has an operating loss carryover. The loss may not be used by the corporation after the election and it may not be passed through to the stockholders. The loss may be revived if the election is terminated. Each year the election is in force counts as a year in figuring the carryover period, even though the loss has not been used.

Estimated tax. An S corporation must make estimated tax payments for the following taxes: tax on excess passive investment income (¶45.11); tax on built-in capital gains (¶45.8); and investment credit recapture (¶40.22). Payments are made with Form 8109 tax deposit coupons; *see* Form 1120S instructions.

Fiscal-year corporations. If the corporation reports on a fiscal year, the stockholders report their shares of corporate items on their tax returns for the year in which the corporate tax year ends.

A special election must be made to use a fiscal year; *see* ¶45.12.

Important: The following sections discuss general features of the S election, the implementation and review of which require the services of an experienced tax accountant or attorney. A detailed discussion of these issues along with the particular objectives of an election may be found in tax services dealing with corporate tax problems and in IRS Publication 589.

¶45.6 Stockholder Reporting of S Corporation Income and Loss

S corporations are subject to tax reporting rules similar to those applied to partnerships. However, shareholders who work for the corporation are treated as employees for FICA purposes. They do not pay self-employment tax on their salary income or other receipts from the corporation.

Allocation to shareholders. The following items are allocated to and pass through to the shareholders based on the proportion of stock held in the corporation:

- Gains and losses from the sale and exchange of capital assets and Section 1231 property, as well as interest and dividends on corporate investments and losses. Investment interest expenses subject to the rules of ¶15.10 also pass through.
- Tax-exempt interest. Tax-exempt interest remains tax free in the hands of the stockholders but increases the basis of their stock. Dividends from other companies may qualify for the exclusion.
- First-year expense deduction.
- Charitable contributions made by the corporation.
- Foreign income or loss.
- Foreign taxes paid by the corporation. Each stockholder elects whether to claim these as a credit or deduction.
- Tax preference items.
- Recovery of bad debts and prior taxes.

If your interest changed during the year, your pro rata share must reflect the time you held the stock.

Basis limits loss deductions. Deductible losses may not exceed your basis in corporate stock and loans to the corporation. If losses exceed basis, the excess loss is carried over and becomes deductible when you invest or lend an equivalent amount of money to the corporation. This rule may allow for timing a loss deduction. In a year in which you want to deduct the loss, you may contribute capital to the corporation. If a carryover loss exists when an S election terminates, a limited loss deduction may be allowed.

The Tax Court and several federal appeals courts have held that an S corporation shareholder's basis is not increased by guaranteeing a loan to the corporation where there is no actual economic outlay. The Tax Court disagrees with the approach of another federal appeals court that allowed an increased basis where the lender looked to the guarantor-shareholder as the primary obligor on the guaranteed loan.

Reporting S Corporation Items

Your company must give you a copy of Schedule K-1 (Form 1120S), which lists your share of income or loss, deductions, and credits that must be reported on your return. For example, your share of business income or loss is reported on Schedule E and is subject to passive activity adjustments, if any. Interest and dividends from other corporations are reported on Schedule B, capital gains and losses on Schedule D, Section 1231 gains or losses on Form 4797, and charitable donations on Schedule A. Tax preference items for alternative minimum tax purposes are also listed. For reporting company payments of health premiums, *see* ¶45.10.

Passive activity rules limit loss deductions. Losses allocated to you may be disallowed under the passive activity rules discussed at Chapter 10.

Expenses owed to related shareholders. An S corporation is deemed to be on the cash method of accounting for purposes of deducting business expenses and interest owed to cash basis related shareholders. Therefore, expenses accruing to such stockholders are deductible only when paid to the stockholders.

EXAMPLE

In 1995, a calendar-year S corporation accrues $5,000 of salary to a related employee-stockholder. It does not pay the salary until February 1996. In 1996, the $5,000 is deductible by the corporation and reported by the employee-stockholder as income.

CAUTION

Family Corporations

The IRS has the authority to change the amounts of items passed through to stockholders to properly reflect the value of services rendered or capital contributed by family members of one or more S corporation shareholders. If you are the member of a family of an S corporation shareholder and perform services or furnish capital to the corporation without receiving reasonable compensation, the IRS may reallocate salary or interest income to you from the other shareholders to reflect the value of your services or capital. The term "family" includes only a spouse, parents, ancestors, children, and any trusts for the benefit of such relatives.

Basis adjustments. Because of the nature of S corporation reporting, the basis of each shareholder's stock is subject to change. Basis is increased by the pass-through of income items and reduced by the pass-through of loss items and the receipt of distribution. Because income and loss items pass through to stockholders, an S corporation has no current earnings and profits. An income item will not increase basis, unless you actually report the amount on your tax return. The specific details and order of basis adjustments are listed in IRS Publication 589.

See also ¶45.14 for a new basis adjustment rule for tax years beginning after 1996.

Allocating income and loss for changes in stock ownership during the year. In a year stock ownership changes, income and loss items are either allocated on a daily basis or all persons who were stockholders during the entire taxable year may elect to allocate income and loss items as if there were two short taxable years, the first year ending on the date the shareholder's interest ended.

Choose the method providing the best overall tax benefit for the shareholders. Different tax results will occur, especially if substantial loss items were incurred in one short year and income items in the other short year. The daily allocation method will average the items between the two years. The short-period method basis will place the items in the period they were incurred. The allocation of items for each short taxable year is determined according to corporate records and work papers. The following Examples illustrate how the allocation on a daily basis is made.

EXAMPLES

1. A calendar-year corporation incurs a loss of $10,000. Smith and Jones each own 50% of the stock. On May 1, Smith sells all of his stock to Harris. For the year, Smith was a shareholder for 120 days, Jones for 365 days, and Harris for 245 days. The loss is allocated on a daily basis; the daily basis of the loss is $27.3973 ($10,000 divided by 365 days). The allocation is as follows:

   Smith: $1,644 ($27.3973 × 120 days × 50% interest)

   Jones: $5,000 ($27.3973 × 365 days × 50% interest)

   Harris: $3,356 ($27.3973 × 245 days × 50% interest)

2. Same facts as in Example 1, except that on May 1, Smith sells only 50% of his stock to Harris. The allocation for Smith accounts for his 50% interest for 120 days and his 25% interest for the remainder of the year.

   Smith: $3,322 ($27.3973 × 120 days × 50% plus $27.3973 × 245 days × 25%)

   Jones: $5,000 (as above)

   Harris: $1,678 ($27.3973 × 245 days × 25%)

¶45.7 Qualifying Tests for an S Election

The election may be made for a domestic corporation which is not a member of an affiliated group and which has—

1. No more than 35 stockholders (75 stockholders for tax years beginning after 1996), all of whom must agree to the election. For purposes of the stockholder test, a husband and wife (and their estates) are counted as one shareholder, regardless of how they hold the stock. However, when consenting to S corporation status, each spouse must consent separately. When spouses divorce, each spouse is treated as a separate stockholder, even though they own stock jointly.

For purposes of the stockholder test, each beneficiary of a voting trust is counted as a stockholder.

Each minor owning stock held by a custodian is counted. The minor, or his or her legal or natural guardian, must consent to the election. The same rule applies to incompetents.

2. Stockholders who are either U.S. citizens or residents, estates, or certain trusts. You may not make the election if a nonapproved trust, partnership, or another corporation owns stock in your company. The following trusts may be electing shareholders: (1) A trust all of which is treated for tax purposes as owned by an individual (grantor trust) who is a U.S. citizen or resident. The trust may continue as a shareholder for a 60-day period following

the death of the owner; the 60-day period is expanded to two years for tax years beginning after 1996. (2) A voting trust. (3) In taxable years beginning before 1997, a testamentary trust which receives the stock under the terms of a will, but only for a 60-day period beginning on the day on which such stock is transferred to it. In taxable years starting after 1996, the holding period for testamentary trusts is extended to two years. The creation of a bankruptcy estate by filing a petition for bankruptcy does not result in a nonqualified stockholding. (4) A qualified Subchapter S trust. A qualified trust is one in which all of the income is distributed currently to a beneficiary who is a U.S. citizen or resident and who has elected to have the trust qualify. There may be only one income beneficiary at any one time and a new election must be made for each successive income interest. Where the trust terminates during the life of the income beneficiary, all the assets must be distributed to that beneficiary. Trust shares that are treated as separate trusts by the tax law also qualify.

See ¶45.14 for new law provisions that allow an electing small business trust in taxable years beginning after 1996 to hold S corporation stock.

3. One class of stock. You may not make the election if your company has common and preferred stock. Differences in voting rights will not cause one class of stock to be treated as two classes. Only outstanding stock is counted in determining whether there is one class of stock. Treasury stock or unissued preferred stock of a different class does not disqualify the election.

The issuance of options and warrants to acquire its stock and convertible debentures does not disqualify the election.

Straight debt instruments bearing a reasonable interest rate are not treated as a second class of stock. Shareholder loans are treated as straight debt provided: (1) the loan is a written unconditional promise by the corporation to pay a specified sum on demand or on a set date; (2) the interest rate and payment date are not contingent on corporate profits or on the discretion of the corporation; and (3) the debt is not convertible into stock.

A corporation with an inactive subsidiary may make the election as long as the subsidiary has no gross income.

¶45.8 Filing an S Election

The corporation makes an election by filing Form 2553 with the IRS. All shareholders must sign written consents to the election in the space provided on Form 2553 or in an attached statement. If the election is made after the start of the first year for which the election is to be effective, consents must be filed by all shareholders who held interests *before* the date of election, even if they have sold their interests.

An election may be filed during the entire taxable year before the year in which the election is to be effective and before the 16th day of the third month of the taxable year to which the election applies. An election which is ineffective because of late filing is automatically effective in the following year. Even if the election is filed on time within the first two months and 15 days of the current year, the election will not take effect until the following year unless all those with shareholders' interests before the filing date consent.

See ¶45.14 for IRS authority to excuse inadvertent election failures.

EXAMPLES

1. A calendar-year corporation wants to elect S corporation status for 1997. It may file an election on Form 2553 any time during 1996 or on or before March 17, 1997.

   If Form 2553 were filed after March 17, 1997, the election would take effect in 1998. However, under the new law, the IRS may allow the election for 1997 if it determines there was reasonable cause for the late filing.

2. A Form 2553 filed by a calendar-year corporation on March 10, 1997, does not contain the written consent of a shareholder who sold his interest in February 1997. The election will not take effect until 1998. Under the new law, the IRS may allow the election for 1997 if the failure to obtain the consent was inadvertent, timely steps to obtain the consent were taken, and the corporation and shareholders agree to IRS-required adjustments.

Once a valid election is made, it is effective for all following tax years, unless revoked or terminated under the rules of ¶45.9.

A valid election may not be filed before a corporation is formally incorporated. The first day of a tax year of a new corporation does not begin until one of these events occurs: it has shareholders, acquires assets, or begins doing business. However, if, under state law, corporate existence begins with filing articles of incorporation, even though the corporation has no assets and does not begin doing business until a later date, the first day of the tax year begins on the date of such filing.

New shareholders. A new shareholder does not have to file any consent, nor can he or she terminate the election. However, a majority stockholder may revoke the election; *see* ¶45.9.

Newly Organized Corporation

Usually, the first tax year of a newly organized corporation will be for a period less than 12 months. An election may be made for this short tax year as long as it is made before the 16th day of the third month of the corporation's first taxable year. If the first taxable year of a new corporation is for a period of less than two and a half months, the election may be made for that year within two and a half months from the beginning of the taxable year. The first taxable year begins when the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first.

Built-in-gains tax. If an S election is made by a C corporation—that is, one already in existence and subject to regular corporation tax—the S corporation may have to pay tax on the sale of appreciated property held by the company before the election. The gain

must be reported by the S corporation if the property is sold or distributed within 10 years of the date of the S election. The rule applies to elections made after December 31, 1986, but not to S elections made before or on that date. Small qualifying S corporations that made an S election before 1989 may be able to avoid this built-in-gains tax if more than 50% of the stock is owned by 10 or fewer individuals, estates, or certain trusts, and the value of the corporation does not exceed $10 million. For further details, *see* Form 1120S and IRS Publication 589.

Corporations making S elections before 1987 are subject to the capital gains tax discussed at ¶45.13.

¶45.9 Revocation or Termination of an S Election

An election may be revoked or may automatically terminate because the corporation no longer qualifies as an S corporation.

Revocation. Shareholders owning a majority of stock may agree to revoke the election by filing a statement of revocation. They may specify the future effective date of the revocation. If they do not fix a date, the revocation is effective on the first day of the taxable year in which the revocation is filed if filed on or before the 15th day of the third month of that year; if filed later in the year, the effective date is the first day of the following taxable year.

Termination. An election terminates when a company no longer qualifies under the rules of ¶45.7. A termination is effective as of the date the corporation no longer qualifies as an S corporation. However, as discussed below, an inadvertent termination may be waived by the IRS.

The last day of the S corporation's short taxable year is the day before termination is effective; the day that termination is effective starts a short taxable year as a C corporation. A Form 1120S must be filed for the short S corporation year and a Form 1120 for the short C corporation year. The corporation's items of income and loss are allocated to the two short taxable years on a daily basis unless a unanimous election to have items assigned to the two short years under normal accounting rules is made by all of the persons who are shareholders in the corporation at any time during the S short taxable year and all persons who are shareholders on the first day of the C short year. For purposes of computing the corporate tax, the taxable income for the C short year must be annualized. This is true regardless of the method of allocation used for allocating income and loss items.

The pro rata allocation method may not be used if there is a sale or exchange of 50% or more of stock during the year of termination.

Choosing Allocation Method

It is important to determine tax consequences under the daily allocation method and the normal accounting method. Choose the method providing the best overall tax consequences for the shareholders reporting their allocated amounts for the short S corporation year and for the corporation reporting as a C corporation for the second short year. Different tax results will occur, especially if substantial loss items were incurred in one short year and income items in the other short year. The daily allocation basis will average these between the two years. The normal accounting allocation will place the items in the period in which they were incurred.

Election following termination. When an election is revoked or terminated in a taxable year beginning after 1996, you may not make another election until the fifth year following the year in which the election was revoked or terminated, unless the IRS gives its consent. The IRS will not consent to an election before the end of the five-year period if the termination is considered reasonably within the control of the corporation or controlling shareholders.

Under the new law, the five-year waiting period does *not* apply to an election termination occurring in a tax year beginning before January 1, 1997.

Inadvertent termination. The IRS may *waive* the termination if it decides that the termination was inadvertent and steps are taken by the corporation to re-establish its qualified status within a reasonable time after discovering the disqualifying event, and the corporation and each shareholder agree to adjustments required by the IRS.

Under the new law, the IRS is given authority to retroactively waive inadvertent terminations for tax years beginning after December 31, 1982.

¶45.10 Tax on Fringe Benefits Received by Stockholders

Owners of more than 2% of the stock will realize taxable income for receiving fringe benefit coverage such as in employee group insurance and accident and health plans.

Health Insurance Premiums

Health insurance premiums paid by an S corporation for more than 2% stockholders are treated as wages, deductible on Form 1120S by the corporation and reported to the stockholders on Form W-2.

A more-than-2% shareholder who reports premiums as wages for 1996 may deduct 30% of the premium on Line 26 of Form 1040 as an adjustment to income. In 1997, the deduction increases to 40%.

¶45.11 Passive Investment Income

A 35% tax may be imposed on an S corporation if at the end of the tax year it has accumulated earnings from taxable years prior to the election and its passive investment income exceeds 25% of gross receipts. Passive investment income includes dividends, interest, rents, royalties, and securities sale gains.

If a corporation does have accumulated earnings and passive investment income exceeding 25% of gross receipts, a portion of the excess passive income is subject to tax. A worksheet included in the instructions to Form 1120S is used to compute the tax. The tax does not apply if the corporation has been an S corporation since the date of incorporation.

The IRS has authority to waive this tax where the corporation proves that it had determined in good faith that it did not have accumulated earnings and profits at the close of the taxable year, and the earnings and profits were distributed within a reasonable period of time after the corporation determined that it did have accumulated earnings and profits.

Caution. The S election may be terminated if for three consecutive years the company has prior accumulated earnings and passive investment income exceeding 25% of gross receipts.

¶45.12 Fiscal-Year Restrictions

S corporations must report on a calendar-year basis unless a fiscal-year election is made. A fiscal year may be based on a business purpose. Alternatively, Code Section 444 allows a fiscal year that provides a deferral period to owners of no more than three months. On Form 2553, an electing S corporation makes a fiscal-year request based on a business purpose. If the corporation wants to make a Section 444 election, it indicates such intent on Form 2553, but the actual election is made on Form 8716. *See* the instructions to Form 2553 and Form 8716 for details on the fiscal-year election. Furthermore, if a Section 444 election is made, a special tax computation is required for each fiscal year. If the computed tax is over $500, it must be paid to the IRS on Form 8752. No tax is due for a newly formed corporation's first year of existence, but Form 8752 must be filed for that year. If payments for a prior year exceed the required payment for the current year, a refund for part of the prior payment may be obtained on Form 8752.

¶45.13 Tax on Capital Gains

For corporations that made an S election before 1987, a special tax is imposed to prevent the use of the election for the pass-through of substantial capital gains. The tax applies if taxable income for the year exceeds $25,000 and the net capital gains exceed $25,000 and 50% of taxable income.

The tax may not apply to a corporation that has been an S corporation for the three preceding taxable years or to a new corporation that has been in existence for less than four years and has been an S corporation for that entire period. *See* instructions to Schedule D of Form 1120S for details.

The tax does not apply if the S election was made after 1986. However, such corporations are subject to the built-in gains tax discussed at ¶45.8.

¶45.14 New Law Changes for S Corporations

Here are highlights of the new law changes for S corporations, most of which take effect for tax years beginning after 1996:

Shareholder cap increased to 75. The maximum number of eligible shareholders of an S corporation is increased from 35 to 75 for tax years beginning after December 31, 1996.

Some exempt organizations may be shareholders. Qualified retirement plan trusts or 501(c)(3) charitable organizations may be S corporation shareholders for tax years beginning after December 31, 1996.

Electing small business trusts may hold stock in S corporations. All beneficiaries of a small business trust must be individuals or estates eligible to be S corporation shareholders, except that a charitable organization may hold a contingent remainder interest. Further, no interest in the trust may be acquired by purchase of stock. Interests must be by gift, bequest, or other nonpurchase acquisition.

Each current beneficiary of the trust is counted as a shareholder for purposes of the 75 shareholder test. The new provision applies in tax years beginning after December 31, 1996.

Subdivided realty. S corporations may qualify under Sec. 1237 for treating unimproved subdivided real property held for five years as capital gain. *See* ¶31.3.

Holding period for testamentary trust expanded to two years. In taxable years beginning after 1996, the 60-day period for testamentary trusts holding S corporation stock increases to two years. The period starts on the date of the stock transfer into trust.

S corporation may own C or qualified S subsidiaries. In taxable years beginning after 1996, an S corporation may own a controlling interest in a C corporation, but may not file a consolidated return with its affiliates. It may also set up a qualified S subsidiary in which it owns 100% of the stock.

Financial institutions. In taxable years beginning after 1996, certain financial institutions may elect S corporation status. Further, financial institutions lending money may hold debt obligations which will not be treated as a second class of stock disqualifying the election.

IRS may approve invalid elections. The IRS may waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain required shareholder consents, including elections affecting qualified S trusts. The IRS may specify certain corporation and shareholder adjustments as a condition of approving the election.

The IRS may also treat late-filed S elections as timely if there is reasonable cause justifying the late filing. These provisions are retroactively effective for tax years beginning after December 31, 1982.

Repeal of partnership-like audit rules applied to S corporations. In tax years beginning after December 31, 1996, S corporations and shareholders will no longer be subject to the unified audit rules that are applied to partners and partnerships. However, shareholders must report items consistently with the S corporation's treatment on its return or identify the inconsistency.

Post-termination transition period. In tax years beginning after December 31, 1996, a former S corporation's post-termination period includes the 120-day period beginning on the date of any audit determination following the termination of the S corporation's election that adjusts items of income, loss, or deduction claimed by the former S corporation. Distributions made by a former S corporation during a post-termination period are treated as if the distributions were made by an S corporation; distributions made after the post-termination period are generally treated as made by a C corporation.

Consent of affected shareholders to terminate year. In tax years beginning after December 31, 1996, the election to close the books of an S corporation when a shareholder's interest is terminated is made by the S corporation and all "affected shareholders," rather than by all shareholders. The closing of the books applies only to the affected shareholders. An affected shareholder is any shareholder whose interest is terminated and all shareholders to whom the terminating shareholder has transferred shares during the year. If the terminating shareholder transferred shares to the corporation, all persons who were shareholders during the year are treated as affected shareholders.

Retroactive re-election without five-year wait. Any termination of an S election in a tax year beginning before January 1, 1997, is disregarded. Thus, any small business corporation that terminated its S election within the five-year period immediately preceding the August 20, 1996, date of enactment may re-elect S status without the IRS's consent.

Adjustments before the loss limitation. In tax years beginning after December 31, 1996, basis adjustments for distributions during the tax year are made before applying the loss limitation for the year. Distributions reduce a shareholder's adjusted basis before determining an allowable loss, but the loss does not reduce the adjusted basis for purposes of fixing the tax status of the distributions. Where an S corporation has accumulated earnings and profits, the accumulated adjustments account is computed without regard to any net negative adjustments for the year. The excess of losses and deductions over income is disregarded. This treatment is similar to that applied to partnership distributions.

Income in respect of a decedent (IRD). A person who inherits stock in an S corporation must treat as income in respect to a decedent the pro rata share of any item of income of the corporation that would have been IRD income if acquired directly from the decedent. The basis of the stock is reduced by the extent to which the value of the stock is attributable to IRD income. This rule applies to stock inherited from decedents dying after August 20, 1996.

¶45.15 Limited Liability Company (LLC)

Limited liability companies (LLCs) are a relatively new form of business entity devised to allow more investors to participate in a venture than allowed in an S corporation. Almost all states have authorized the creation of LLCs as a means of combining partnership and corporate benefits. If the LLC qualifies as a partnership for federal tax purposes under IRS tests, the LLC investors benefit from the pass-through of income and deductions without incurring a federal corporate tax (state law treatment varies). At the same time, LLC investors obtain the corporate benefit of limited liability, which is personal liability protection from the LLC's debts without having to structure the business as an S corporation. However, professionals may not avoid liability for personal malpractice, and some states may not permit professionals to form LLCs.

State laws differ as to the business flexibility of LLCs. An LLC that does business outside of the state in which it was organized must register with officials of the other states. Generally, the laws of the "home" state will apply, but some states may prevent a foreign LLC from exercising powers or obtaining benefits that are not available to domestic LLCs.

See also ¶45.1 for the IRS proposal to allow election of corporate or noncorporate status.

Farm Income and Loss

¶45.16 Who Is a Farmer?

The term "farmer" includes all individuals, partnerships, syndicates, and corporations that cultivate, operate, or manage a farm for profit or gain, either as owners or tenants. Thus, partners in a partnership which operates a farm are considered farmers.

The term "farm" includes stock, dairy, poultry, fruit and truck farms, plantations, ranches, and all land used for farming operations. A fish farm where fish are specially fed and raised, and not just caught, is a farm. Animal breeding farms, such as mink, fox, and chinchilla farms, are also considered farms.

CAUTION

Gentleman Farming

To be treated as farmers, individuals must be engaged in farming for gain or profit. Farm losses of a part-time or "gentleman" farmer may be disallowed on the grounds that the farm is not operated to make a profit but is a hobby. The hobby rules explained at ¶40.9 apply in determining the existence of a profit motive in farming operations. Favorable evidence of an intention to make a profit are: You do not use your farm just for recreation. You have tried to cut losses by switching from unsuccessful products to other types of farming. Losses are decreasing. Losses were caused by unexpected events. You have a bookkeeping system. You consult experts. You devote personal attention to the farm.

Farm loss deductions may also be restricted by at-risk rules and passive activity rules of Chapter 10.

If your farm losses exceed your other income, *see* ¶40.18.

Important. A guide to reporting farm income and loss may be obtained at your local Internal Revenue office or from your County Farm Agent. It is called Farmer's Tax Guide (IRS Publication 225).

¶45.17 Forms Farmers File

Use Schedule F to report income from a farm you operate as an individual. The profit or loss computed on Schedule F is then included in Form 1040. Schedule F is also used as a basis for figuring self-employment tax on Schedule SE, which must also be filed with Form 1040. Sales of farm equipment and dairy or breeding livestock are reported on Form 4797.

If you operate through a partnership, the details of your farm operation are shown on Schedule F and Form 1065. Your share of the partnership net income or loss is included in Form 1040.

Individual farmers who are on a calendar-year basis (ending December 31) may pay their entire 1996 estimated tax on Form 1040-ES by January 15, 1997, if at least two-thirds of 1996 estimated gross income is from farming, or if at least two-thirds of 1995 total gross income was from farming. A final return is required by April 15, 1997. However, you may file your final return by March 3, 1997, instead of making an estimated tax payment for 1996 in January 1997.

¶45.18 Farmer's Social Security

Farmers follow special rules for figuring their self-employment income and tax. If your gross income from farming is not more than $2,400, you may figure your self-employment income in either of two ways:

- You may reduce your self-employment income by your allowable deductions (as any other self-employed person would do), and pay the self-employment tax on the difference; *or*
- You may consider your net self-employment income from farming to be two-thirds of your gross farming income.

If your gross income from farming is more than $2,400 but your net self-employment income (figuring it in the usual manner by reducing gross income by the farm's expenses) is less than $1,733, you may treat $1,600 as your net farm self-employment income.

Self-employment tax on farm income is figured on Schedule SE. *See also* IRS Publication 225.